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C O N F I D E N T I A L SECTION 01 OF 02 BAKU 000757

SIPDIS

EUR/CRAC FOR JOHN CLOONEY; EEB FOR ESC/IEC/EPC

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SUBJECT: AZERBAIJAN-IRAN COOPERATE ON NATURAL GAS, CONSIDER
EXPANSION

REF: NONE

Classified By: Acting DCM Rob Garverick

¶1. (C) SUMMARY: The Azerbaijan-Iran natural gas relationship is expanding and will continue to be strategically important to both countries. This opinion was conveyed to polecon officer in separate meetings with Azerigaz Vice-Chairman, Nazim Sadmed-zadeh; State oil Company of Azerbaijan Vice President Elshad Nassirov; and long-time energy analyst for Azerbaijani TURAN news, Ilham Shaban. According to these observers, the energy relationship meets critical needs of both nations. Azerbaijan is reliant on Iran,s gas for the isolated autonomous region of Nakhchevan, while Iran counts on southern Azerbaijan to supply gas to its northern territories. The relationship is based on a swap agreement, a practice increasingly used in the region to meet energy needs. All agreed the swap practice is particularly beneficial when dealing with Iran as it minimizes political and commercial risk for the Government of Azerbaijan. Since GOAJ is not investing in the Iranian gas sector and no monetary exchange or profit is being made by either government, GOAJ is confident it will not face international criticism nor violate any international sanctions.

Background to the Natural Gas Swap Relationship

¶2. (C) Azerbaijan-Iran cooperation in natural gas is primarily limited to a swap agreement that involves an Iranian gas supply to Nakhchevan and an Azerbaijani gas supply via its southern border to Astara, Iran. The exchange officially commenced in 2004 and is based on acute supply deficiencies in both countries. The closure of land borders between Armenia and Nakhchevan as a result of the Nargoro-Kharabakh conflict has severely limited Azerbaijan,s options for supplying gas and other necessities to the enclave. According to the GOAJ, Iran--with the sole land border open for entry to the Nakhchevan--is the only practical gas supplier for Nakhchevan. In terms of Iranian needs, the most efficient way to provide gas to northern Iran is via Azerbaijan as Iran,s major gas fields are in the south of the country. Iran also relies on Azerbaijani gas because of the growing demand in its northern territories and its lack of adequate investment in domestic production and infrastructure.

Why a Swap Program

¶3. (C) All three interviewees said energy swaps are a growing practice in the region because they limit financial and political risks to each government. Under such arrangements, including the Azerbaijan-Iran gas exchange, each government is responsible for building and maintaining the necessary infrastructure and ensuring gas transit to the other country. If one side disrupts service, the other party can follow

suit. As Azerigaz official Sadmed-zadeh said 'we sink or swim together in this scenario.' According to TURAN energy analyst, swaps with Iran are particularly popular, not only because of the two nations, geographical-based needs but because the government of Azerbaijan feels less exposed to international criticism and possible sanctions. By engaging in swaps the GOAJ avoids making investments in Iranian gas sector and neither side realizes a monetary profit. In fact, according to the agreement, no money changes hands between the two parties. Shaban also surmised the GOAJ prefers swaps with Iran because the negotiations do not get bogged down in cost issues which seem to hamper all other such deal-making with the Iranian Government. Shaban said Iran is "always trying to broker a deal where it gets everything for free" from the other party.

Increasing volumes exchanged

¶4. (C) According to Sadmed-zadeh the swap volume exchanged between Azerbaijan and Iran has increased by 50 million cubic meters each year since 2004. In 2004, 50 million cubic meters were exchanged and by 2007, 200 mcm were swapped. In the first quarter of 2008, 122 mcm have been exchanged. Nazim said the pipeline capacity is not functioning at capacity and could swap more than 300 mcm without a problem. The gas exchange is not balanced as Azerbaijan provides an additional 15 percent of total gas exchanged to Iran annually to cover transit costs from Iran.

¶5. (C) Shaban and Nassirov both projected that gas cooperation with Iran would continue to expand. According to

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Nassirov, Iran has already proposed to Azerbaijan that it purchase all the natural gas from Phase II of Shah Deniz when it becomes operational in 2012. While Nassirov did not say the proposal was likely, he also would not rule out some degree of additional gas sales to Iran in the future. (NOTE: Iran has about a ten percent ownership stake in the Shah Deniz project, varying slightly between the field itself and the associated pipeline.)

¶6. (C) COMMENT: Despite tension between the two governments--particularly over Caspian delimitation and Iran's perceived alliance with Armenia--Azerbaijan and Iran, as evidenced by energy cooperation, have pursued a strategic relationship to advance their immediate interests. It seems feasible that if the geopolitical situation does not drastically change in the region, the Azerbaijan-Iran bilateral relationship, particularly in the energy sector, could continue to expand. Without resolution to the Nagorno-Karabakh situation, Azerbaijan will continue to rely on Iran to meet the energy needs of Nakhchevan. If Turkey continues to frustrate Azerbaijan's pipeline transit proposals, Azerbaijan may seek out neighbors, like Iran or Russia who would be willing to work together on energy projects. (NOTE: In the past two years Iran has made several high level visits to Azerbaijan which include submission of proposals to increase cooperation in electricity, oil, and gas.) While we accept Iran as the only practical gas supplier for Nakhchevan at this time, Post will continue to discourage Azerbaijan from expanding its energy relationship with Iran beyond this exchange or increasing its ties with Iran in other sectors.

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